Incentives and Structure:
Development of Pay Practices in the 20th Century

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Jan. 3, 2002

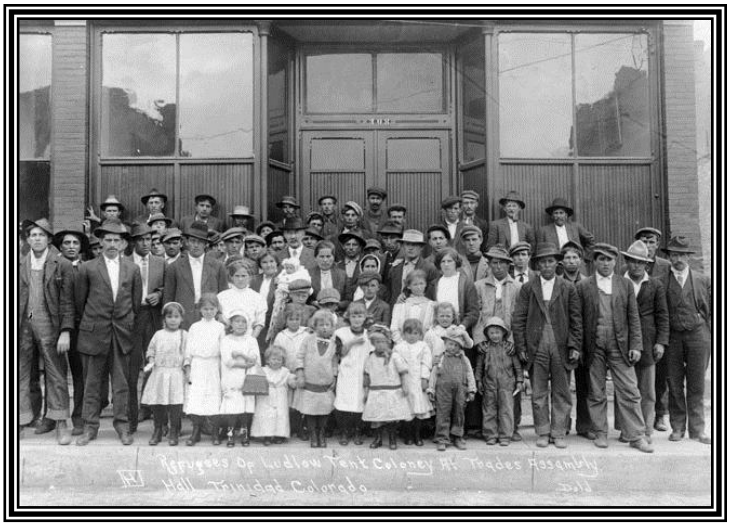
"You ask me how we regulate wages; I can only reply that there is no idea in the modern social economy which at all corresponds with what was meant by wages in your day."

Edward Bellamy writing in 1887 in the novel *Looking Backwards* about a utopia in the year 2000

"We have a stable unemployment rate of around 4%, we have good economic growth and low inflation, this is nirvana."

Merrill Lynch economist commenting on the actual year 2000

Strike at Rockefeller-owned Colorado Fuel and Iron Co. leads to Ludlow Massacre: 1914



Industrial Relations Counselors formed: 1926

"…Any industry, to be permanently successful, must insure to labor adequately remunerative employment under proper working and living conditions, to capital a fair return upon the money invested, and to the community a useful service… The soundest industrial policy is that which has constantly in mind the welfare of the employees as well as the making of profits, and which, when human considerations demand it, subordinates profits to welfare."

John D. Rockefeller, Jr.

(1923)

"The point is, ladies and gentlemen, greed is good. Greed works, greed is right. Greed clarifies, cuts through, and captures the essence of the evolutionary spirit. Greed in all its forms, greed for life, money, love, knowledge has marked the upward surge in mankind – and greed, mark my words – will save not only Teldar Paper but the other malfunctioning corporation called the USA."

Gordon Gekko, fictional financier in the 1987 film "Wall Street."

"Under the present accounting standards, where surrendered shares are not 'mature,' the stock swap will be considered the functional equivalent of the cash settlement of a stock appreciation right, resulting in variable plan accounting treatment (the compensation expense will be estimated at the time of grant and adjusted in each subsequent accounting period to reflect changes in the fair market value of the company's stock) and ultimately the recognition of an expense equal to the difference between the option exercise price and the fair market value of the company's stock on the date of exercise"

"The Stock Options Book,"
3rd ed., NCEO, 1999

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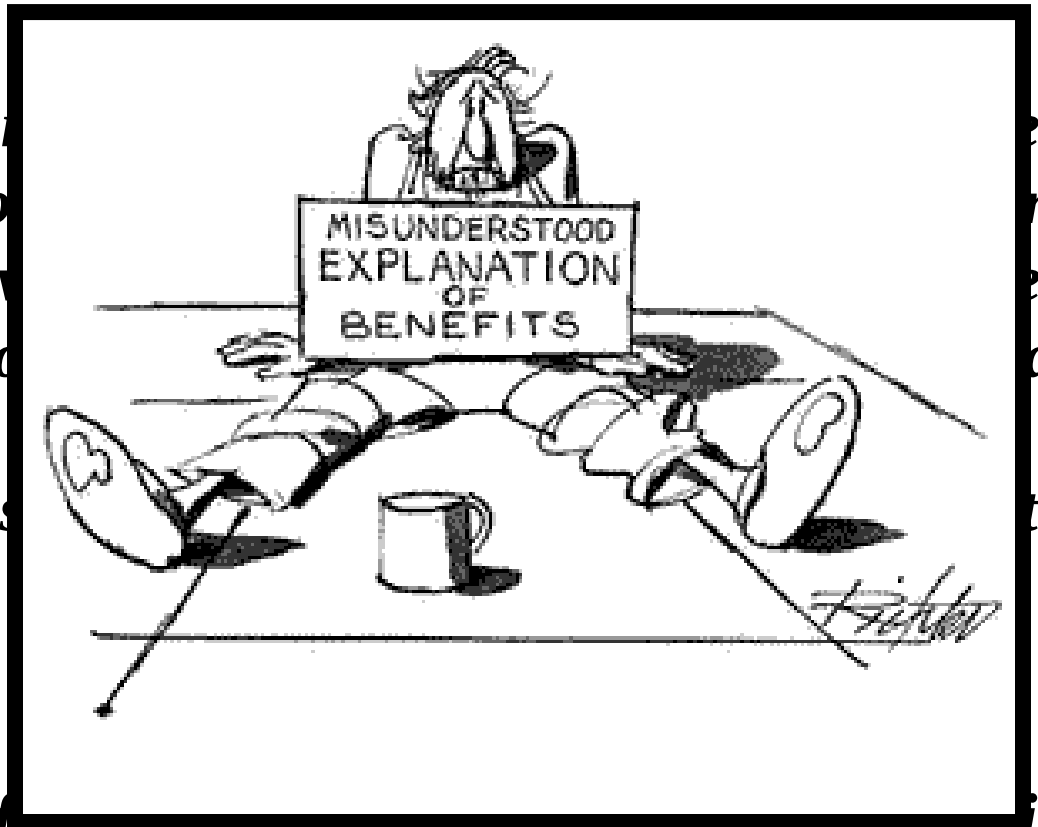

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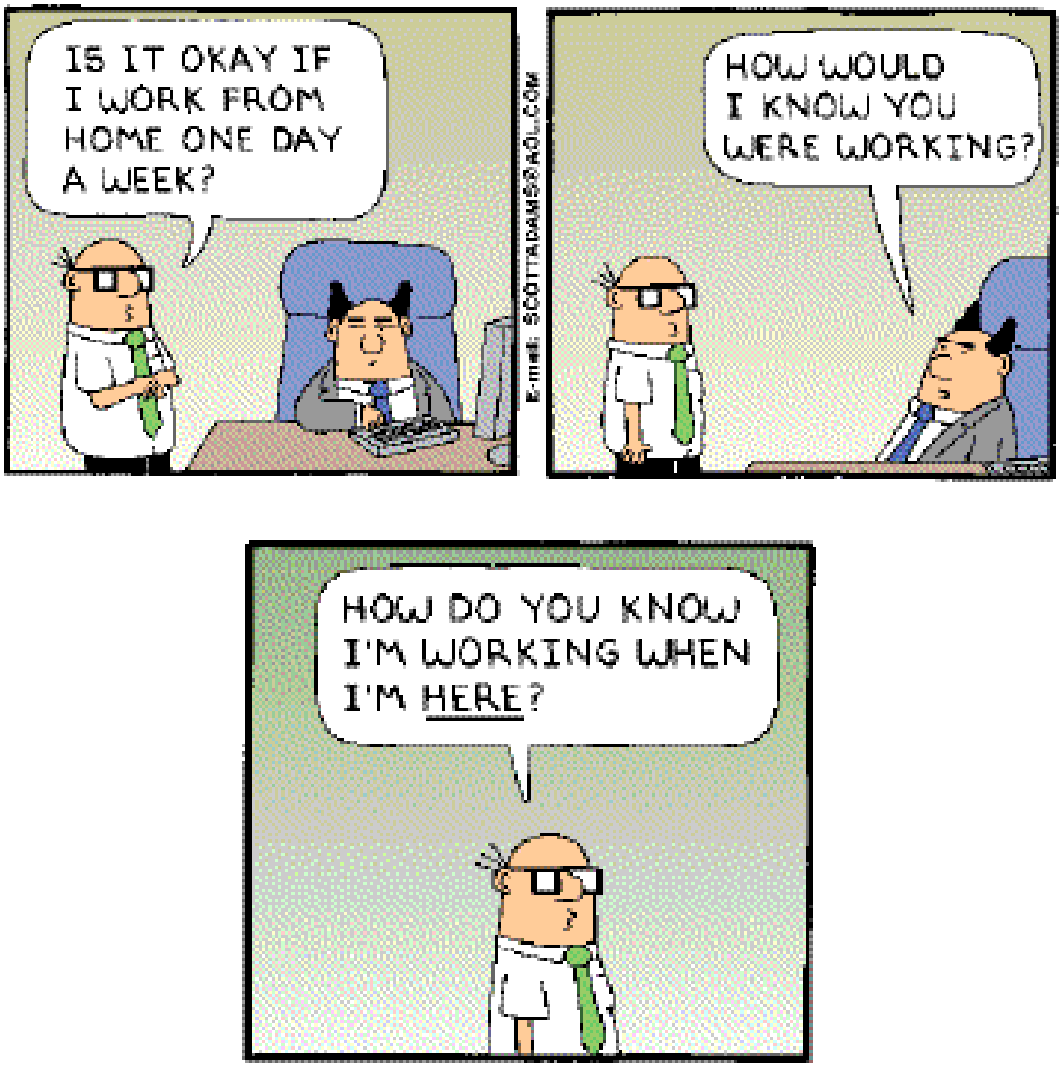

IS IT OKAY IF I WORK FROM HOME ONE DAY A WEEK?
E-mail: SCOTTADAMS@aol.com
HOW WOULD I KNOW YOU WERE WORKING?
HOW DO YOU KNOW I'M WORKING WHEN I'M HERE?

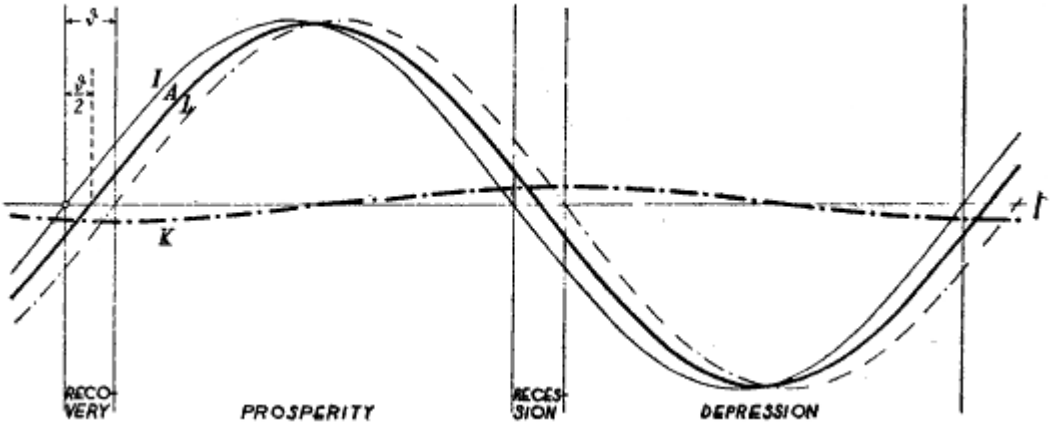
Principal/agent or monitoring problem

Defining Compensation

- **Time-based wages**
- **Social welfare benefits**
- **Individual and small group incentives**
- **Risk sharing plans**

Time-Based Wages

- **Default option**
- **Requires some form of monitoring, supervision, or supplementary reward**
- **Flexible or rigid**
  - **Nominal or real**
  - **With respect of business cycle**



ACCORDING TO THIS SURVEY THE COMPENSATION HERE IS "COMPETITIVE."
COMPETITIVE MEANS NOT THE HIGHEST. SO WE COULD GET PAID MORE IF WE WORKED AT ANOTHER COMPANY?
SHOULD WE CONTINUE WORKING AS HARD AS WE CAN OR SHOULD WE BACK OFF TO A MORE COMPETITIVE LEVEL?
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Even basic pay decisions can have behavioral effects

Social Welfare Benefits

- **Pensions, health insurance, etc.**
- **Often tax incentives**
- **Rigid in sense that do not vary with performance**
- **Can have anti-mobility effects**
  - **Job lock with regard to health care and pre-existing ailments**
  - **Golden handcuffs of defined-benefit pensions**

"There are no medical or pension benefits, but the employees' lounge has excellent free coffee."

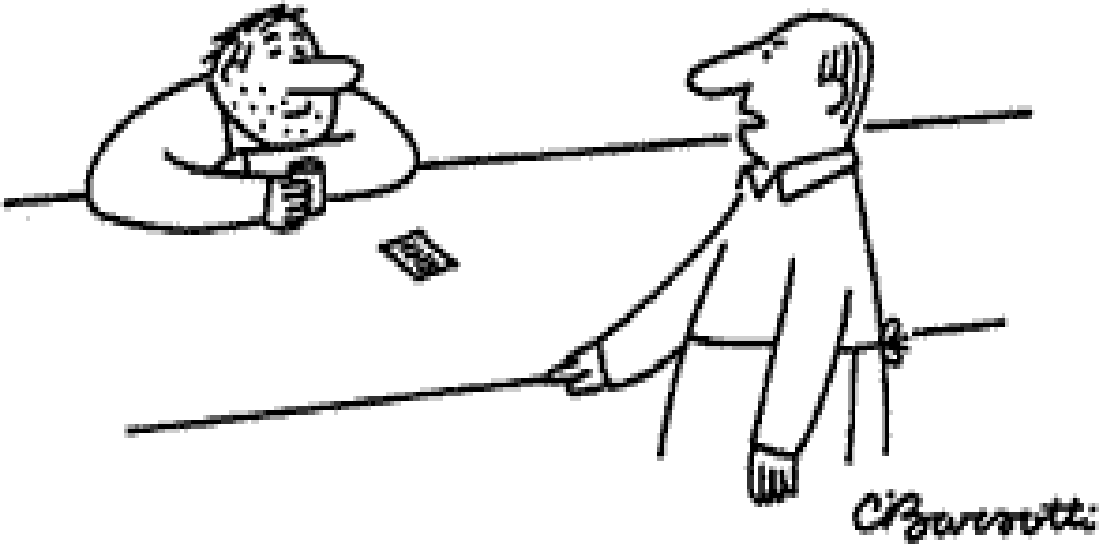
Individual and Small Group Incentives

- **Piece rates**
  - **Excess competition**
  - **Promote waste**
  - **Employees can distort**
- **Elaborate "scientific management" systems**
- **Subjective systems such as merit bonuses based on performance appraisals**

Incentive Design Problem

Risk Sharing Plans

- **Profit sharing**
- **Gain sharing**
- **Employee stock ownership plans (ESOPs)**
- **Other forms of share ownership**
- **Stock options**
- **Classic 1/N problem if seen as incentive**



"I don't want stock options. I want you to pay your tab."

Incentive fads come and go

Public Policy Toward Compensation

- **Firms have micro-level incentives to design efficient pay systems**
- **May be a macro rationale for encouraging certain systems, e.g., Martin Weitzman's case for a "share economy"**
- **Societal rationale, e.g., Louis Kelso's case for ESOPs**

- **Poor policy: FASB retreat on reporting stock option liability**

Data Problems

- **Chamber of Commerce**
- **Bureau of Labor Statistics**
- **Bureau of National Affairs, Inc.**

Alternative Pay Systems

- **Piece rates**
  - **Mentioned in a fourth of union contracts**
- **Profit sharing**
  - **One third of Chamber of Commerce respondents**
  - **One eighth of full-time employees in govt. survey**
- **Gain sharing**
  - **Small, probably under 5%**
- **ESOPs**
  - **11% of Chamber of Commerce respondents**
  - **Under 4% of full-time employees in govt. survey**
- **Stock options**

Alternative Pay Systems

Stock options:

- 1.7% of non-executive employees in 1999
- Up from less than 0.5% in 1993
- 5.3% of employees in establishments with publicly-traded stock
  - One fifth of executives
  - 2% of employees making less than US$35,000
  - 27% of non-executives making > US$75,000

Historical Evolution: Pre-New Deal

- **Wage structure**

  Early development of job design (time & motion), job evaluation, and wage and salary administration through point systems

- **Social welfare benefits**

  Encouragement of employee thrift (predecessors to 401ks); some pensions, etc.

- **Incentives**

  Taylorist piece rates; some union resistance; efficiency wage idea (Ford)

Historical Evolution: Pre-New Deal

- **Risk sharing: stock ownership**
  - **Some large firms encouraged stock ownership as part of thrift plans**
  - **Seen as good PR aside from any incentive effect**
  - **Questionable source of capital argument**
  - **NICB report post crash**
- **Risk sharing: profit sharing**
  - **Seen as inferior to piece rates but useful if piece rates could not be applied**
  - **Wage flexibility argument not cited**

Post-World War II

- **Impact of the Depression**
  - **Stock ownership: "In some cases it was difficult to explain the situation to certain uneducated elements... who could not comprehend why they were not paid in full." (NICB)**
  - **Profit sharing also disfavored**
  - **Unions seek job/income security: GAW becomes SUB**
  - **Unions seek role in wartime piece rate setting: use declines after war**
- **Emphasis on fairness, human relations, in wage setting**
  - **Wage and salary administration institutionalized**
  - **Later basis for comparable worth**

"O.K., if you can't see your way to giving me a pay raise, how about giving Parkerson a pay cut?"

"Fair" pay structure

Post-World War II

- **Social benefits**
  - **Greatly expanded offering of pensions, health insurance**
  - **Union sector an initial center**
  - **Fit with emphasis on security**
  - **Tend to tie workers to firm**
- **1980s and 90s: Pay for performance, erosion of social benefits, reduced security**
- **Next challenge is aging of the workforce**

  Prediction: Aging baby boomers will put renewed value on security and stability.